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April 11, 2011

John V. (Jack) Foley
Chairman
Metropolitan Water District of Southern California
P.O. Box 54153
Los Angeles, CA 90054-0153

Board Agenda Item 8-4: Approve proposed biennial budget for fiscal years 2011/12 and 2012/13 – OPPOSE

REQUEST TO REOPEN 2011/12 BUDGET AND FOR SPECIAL BOARD WORKSHOP TO CONSIDER REVISED 2011/12 BUDGET AND PROVISIONAL 2012/13 BUDGET

Dear Chairman Foley:

We have reviewed Board Memo 8-4 (budget board memo) dated March 30, 2011, and the PowerPoint Presentation for the Finance and Insurance Committee meeting that was posted on the MWD Web site Friday afternoon. We believe new financial information contained in the PowerPoint represents material changes to the information the board has previously been provided. Because of this, it would be premature to adopt any budget at Tuesday's board meeting. We request, and hope that you will agree to defer action on the budget this week and, instead, promptly schedule a Special Board Workshop to give the board an opportunity to reconsider the assumptions included in the 2011/12 and 2012/13 budgets.

New Financial Information
The PowerPoint shows that:

- MWD water sales are trending to be 291,000 acre-feet below budget this year. Not including the Water Authority's QSA supplies (161,000 AF this year), if this trend proves right, MWD's water sales for the year would be 1.475 MAF, the lowest figure in more than two decades.

- From a fiscal standpoint, if the sales trend continues, the budget shortfall this year would be $194 million. MWD plans to cover this revenue shortfall in large part by drawing down its reserves by $126 million. *This is nearly twice the amount included in the budget board memo*, which stated that $64 million would be withdrawn from reserves.

- It appears that this latest forecasted withdrawal of $126 million may cause the Rate Stabilization Fund (RSF) to dip below the board policy minimum level this year. Because not enough cuts are being proposed for 2011/12, the projected budget assumes using RSF to meet the revenue gap. If water sales in the coming budget year track this year, they would be nearly 165,000 acre-feet below the 1.8 MAF sales assumption, leading to an additional revenue shortfall. This revenue gap – combined with the "escrow account" MWD shows reserved against available funds in the RSF – could deplete the RSF fund as soon as next year.

Projected Water Sales

In spite of these clear and alarming trends – *and actual results included in the new financial information* – the proposed budget assumption of 1.8 MAF of water sales for both 2011/12 and 2012/13 poses significant fiscal risks to MWD. Those risks are compounded by assumptions in the budget that *MWD sales will return to 2 MAF in 2013/14 and following years*. Given actual experience over the past three years – and state law requiring retail agencies to achieve 20 percent reductions in per-capita consumption by 2020 – we do not believe these sales projections are prudent assumptions for budgeting purposes. While we recognize that the MWD board will likely lift water supply allocation this week, there is no evidence to suggest that action will result in MWD sales returning to these levels. To the contrary, we believe that MWD water sales in the next fiscal year will more likely track this year since many MWD member agencies – most notably the City of Los Angeles – will be taking advantage of low-cost local water supplies following this favorable water year. These facts should compel the board to use more conservative water sales projections, especially when facing the prospect of depleting the Rate Stabilization Fund.

Insufficient Cost Reductions to Match Lower Sales Base

Overall, staff has not recommended cost reductions for the 2011/12 fiscal year sufficient to match the anticipated lower sales forecasts or actual FY 2010/11 results presented in the new financial information. Because of this, MWD runs the risk of significantly overspending in the coming fiscal year. We have previously communicated to staff a number of suggestions for reduction of CIP expenditures that could be achieved by: delaying or deferring additional projects, including ozone retrofit at Weymouth; using power purchase agreements to achieve solar objectives; and, deferring investment in Hayfield for water supplies that are not needed for the next few years. There are other projects MWD should delete from its budgets entirely, including "system integration" for member agency seawater desalination programs. That project, and other new LRP projects and all member agency subsidies should be suspended until MWD develops a new budget and financial plan to illustrate why it makes sense for MWD to pay its member agencies to buy less water at a time its sales have fallen nearly 300,000 acre-feet below projections.

The specific project deferrals noted above would result in a CIP reduction of at least $115 million, or nearly 20% over the next two-year CIP budget. Undoubtedly, there are other cost-cutting measures MWD could, and should adopt within both the CIP and O&M budgets that would be more consistent with reserve and water sales trends. We want to be clear that the solution to MWD's reduced sales is not to raise water rates – thus adding to the 56% increase in the Tier 1 Treated Rate approved between 2008 and 2012. Rather, the board must take the time now based on the new financial information to review all MWD expenditures with a critical eye, and adopt meaningful reductions that will help MWD stabilize its finances over the next few years and match its spending to a lower and more realistic water sales base.

Deferral of OPEB and PAYGo

We are also concerned that the budget does not address or manage MWD's $450 million liability for other post-employment benefits (OPEB) and that, by failing to do so, is shifting a disproportionate burden to future ratepayers. Similarly, we believe MWD's total CIP should be reduced to the extent necessary to achieve an appropriate level of PAYGo funding. MWD should also budget for the necessary deposits into escrow of increasing amounts annually attributable to MWD's Exchange Agreement with the Water Authority. This amount could total as much as $120 million to $250 million over the next three to five years, yet has not been accounted for, or even discussed during the budget process.

Storage Budget

MWD has failed to meaningfully budget for the costs associated with storing water as part of its water supply reliability program. The costs of storing water in good years are necessary in order to achieve this core strategy of MWD's water resource plans. If MWD is not going to budget for these costs – or actually store as much water in its storage accounts as is available in good years like this – then MWD's entire storage and resource program strategies must be reconsidered. MWD staff has consistently stated that constraints in the Delta mean MWD can count on wet-year supplies in only three of every 10 years - this is one of the three years. We are concerned that MWD may not be maximizing all opportunities to fill its storage accounts this year, as it appears it has not budgeted sufficient funds to do so in the past or in the proposed budgets.

Conclusion

Overall, the budgets as proposed by staff evidence a trend toward deferring a disproportionate share of expenses to the future – solely on the basis of optimistic sales forecasts – rather than grappling with the very real, difficult budget issues confronting MWD now. Temporary deferral of expenses to future years to mitigate rate shock as a result of unanticipated events is one thing, but the prolonged and continued deferrals to the future is not prudent nor sustainable. Similarly, the continued dipping into reserves to meet revenue gaps that could be minimized by cutting expenditures is equally imprudent. This practice could result in depletion of the Rate Stabilization Fund, breach of revenue bond debt service coverage requirements and/or accelerated or mid-year rate hikes as soon as 2012. These are neither desirable, nor acceptable outcomes when the board has other, more responsible options available to it to manage our water supplies – and finances – in an era of declining sales. We recommend that the board reopen the adopted 2011/12 budget to better match expenditures to projected sales and revenues.

In closing, we would note that the MWD budget reflects the ongoing challenges of having very high fixed costs and minimal fixed revenues. The time for the board to address and correct this and the other fundamental policy issues outlined in this letter is long overdue.

Sincerely,

James L. Bowersox	Lynne L. Heidel	Keith Lewinger	Fern Steiner
Jim Bowersox	Lynne Heidel	Keith Lewinger	Fern Steiner
Director	Director	Director	Director

Cc: Jeff Kightlinger, General Manager